March 2014

Connect the dots

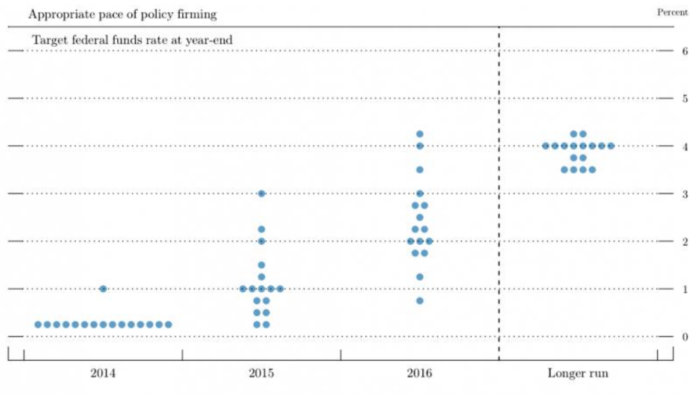
We are all familiar with 'dot-to-dot' puzzles. Whether using numbers, letters, or symbols, the object is to draw a line connecting the dots which will ultimately reveal an image.

While typically performed by children, investors have now been subject to their own dot-to-dot game as we attempt to figure out the economic picture as dictated by the Federal Reserve (Fed). With the economy likely to continue to improve, investors are fixated on the timing and magnitude of eventual rate hikes. This obsession is warranted as a rate hike will be the first of its kind since the summer of 2006.

In 2012, lead by Ben Bernanke, the Federal Reserve created their own dot chart in a move to increase transparency on expectations for the target Federal Funds rate. Each dot is intended to represent where a (Federal Open Market Committee) FOMC member sees the Federal Funds rate at the end of each year.

Recently there has been a growing disconnect within the FOMC on when rate hikes will happen, and what the US Federal Reserve (Fed) Funds rate will be at the end of a particular year. As seen in the most recent dot chart below, the range of results for 2015 and 2016 is enormous. To us, it is extraordinary that one FOMC member can have the 2016 end of year Federal Funds rate at 0.75%, while another can have it at 4.25%. Furthermore, views of the FOMC are even more muddled when the median 2016 Federal Funds rate forecast jumped by 0.50% from 1.75% to 2.25% yet at the same time the FOMC stated that, "this change in our guidance does not indicate any change in the committee's policy intentions as set forth in recent statements."

Throw in newly-minted Fed chair Janet Yellen's clarification that "considerable time" for rate hikes meant six months, it was clear that the FOMC moved the forward guidance needle toward the more hawkish side. Whether intended or not – the Fed has since back-tracked on much of the Yellen testimony in the most recent minutes – the game of connecting the dots in the financial markets is considerably more challenging compared to the puzzles we completed as kids.



While rate hikes are inevitable, we as investors must connect the dots of this enormous puzzle; navigating the global macro environment, interpreting Fed speak, analysing economic data, performing bottom-up security selection, and incorporating extensive risk management processes, to reveal the economic imagery that ultimately guides us in portfolio construction.

We recognise no one person has all the answers, nor can do everything, nor will always make the right call – it requires teamwork.

With the eventual unwinding of unprecedented global monetary stimulus following the worst financial crisis since the Great Depression, there is no longer such a thing as a 'normal' market environment. We foresee greater uncertainty, volatility and risk in the future and as a team, connecting the dots is critical to our future success.

Kapstream's economic picture

When we connect the dots, everything centres around the global recovery, which looks to be taking shape, albeit at a moderate pace. While 2014 news headlines will remain focused on a hard landing in China and risks in the 'shadow banking' sector, we foresee further liquidity, improving reforms and a continuation of growth in the 7½% range.

In the US, we expect improvement in economic data as the exceptionally cold weather season nears an end. Over 2014 we forecast a measured but steady rise in global long-term bond yields (ten year maturities and beyond) as;

- Growth continues to recover in the US (housing, jobs, and consumer confidence)
- The likelihood of a hard landing or debt spiral in China dissipates
- The market prices in a monetary policy 'exit'
- Real yields normalise from alarmingly low levels

In our view, rate hikes remain further away than the FOMC is predicting. However, we don't believe taking large interest-rate positions are warranted in this environment as the information ratio is low and interest-rate volatility will remain high. 10-year US Treasury yields in the 2½ to 3% range appear fairly priced, balancing moderate growth and minimal inflation risks versus the imminent end of Federal Reserve support for the Treasury market amidst a more stable jobs environment. We expect to maintain our current interest-rate duration around the 1 year mark.

US

While US growth is improving, the pace will remain fairly muted and well below the 3.4% average pace for the period following WWII through 2007. Despite an improving consumer, private sector deleveraging will continue and put pressure on the recovery in 2014. And business spending will only improve marginally – business sentiment has fallen in recent months.

Nonetheless, the private sector will continue with moderate gains over 2014. We expect modest acceleration in personal and business spending as housing and equity markets continue to support wealth, despite increases in mortgage rates which will slow the housing recovery. Despite occasional hiccups, employment gains will continue in the 180,000/month range, which could bring the unemployment rate down toward the 6% range by year-end 2014. We expect to re-gain the net remaining 1.3 million lost jobs over the 2008 – 2009 period within this first half of 2014.

We foresee potentially larger job gains in the coming months as the effects of past cold weather pass and more unemployed find jobs. However, inflation will remain under control, still below the Fed's 2% target given the enduring slack in the labour market in the form of lower paid and temporary jobs.

While a continuing US recovery provides our bias for eventual rises in interest rates, we foresee a cap in government yields as other global deflationary risks still remain, particularly in Europe. The European Central Bank (ECB) will continue to play lip service to easy money and quantitative easing, even in the face of growing fundamental structural issues.

The ECB will eventually reach their limit, but we believe they have ample political support to continue current policies through the remainder of 2014. The rationale the ECB has used to continue supporting peripheral countries, i.e., promises of fiscal austerity, has deteriorated over the past 12 months. Peripheral economies will not reach their fiscal targets and austerity will prove to be even more difficult to implement over the long term, but we view this as a 2015 and beyond problem, given the ECB's continuing support.

Australia

In Australia, the Reserve Bank of Australia (RBA) will remain on hold although the currency isn't doing as much of the RBA's work as it had hoped. The transition from mining investment to manufacturing/export sectors will take time and require an even lower AUD. The economy is still functioning at below trend in terms of jobs and sentiment.
We forecast annual 2014 growth around 2.7%, well below the 3.4% long-term average. While the recent 18% fall in the AUD will continue to aid the non-mining and export sectors, these sectors are unlikely to fill the gap created by the fall in mining investment. The RBA will maintain low rates as limited wage growth will stem inflationary pressures and allow continuing support for the housing market.

While equity markets reached new record levels at 2013 year-end, we do not believe current levels reflect strong growth and earnings potential, but rather cost cutting and downward wage pressures which will put more pressure on the labour market and non-mining domestic growth. The downward pressure on wages has kept disposable income levels extremely low.
While we foresee further AUD weakness, the currency is more likely to be driven more by US Fed action and the speed of QE3 unwind rather than by anything in Australia. We expect QE3 will conclude toward the end

of 2014 and provide some further relief for the AUD, although it's hard to see a dramatic fall, particularly as the interest-rate differential between the US and Australia will continue to support financial flows into Australia. With moderately attractive real yields, we like Australian interest-rates relative to the US and the rest of the developed world. We expect USD weakness to continue its reversal in 2014 as the ending of the Fed's quantitative easing programme, combined with stabilising growth, supports the USD over the year.

Asia

Markets will continue to worry about China, but as the 2013 headline stories of the risks of a Chinese hard-landing dissipate, the 2014 story will centre over the growth of Chinese local debt and risks in the 'shadow banking' sector, another red herring in our view. This burgeoning debt of Chinese municipal localities, used to finance infrastructure projects, is unlikely to bring about a major debt crisis in 2014. This growing debt may represent China's largest economic problem, however, material defaults are unlikely and ultimately the central government will allow more tax revenues to flow to localities to pay construction debts. While a recent report showed this debt alarmingly increasing over the past 2½ years, reaching $3 trillion, China's overall total debt at 56% of GDP still compares favourably to most developed countries. We expect Chinese growth will remain in the 7½% range over 2014, allowing China to continue to support the global growth story. Reforms will continue, and we expect eventual liberalisation of deposits rates combined with necessary deposit insurance, although this may take considerable time.

While Asian fundamentals appear fairly solid in both the corporate and sovereign world, a rising rate environment will prove challenging for inflows, similar to the 2nd half of 2013. From a fundamental perspective, sovereign downgrades/negative outlooks appear to be closer to the end of the cycle, unlike much of the remainder of the world, particularly Europe. We will remain more cautious in Asian sovereigns with weaker fiscal fundamentals, i.e. those with deteriorating budgets, current accounts and reserves.

India will remain a top Asian story as weaker fundamentals will provide a challenge to maintaining its investment-grade rating. We will continue to favour investment grade corporates in lower-beta (less volatile) countries such as Korea, China, Hong Kong and Singapore. We expect to hold 10-15% of the portfolio in this region over the course of 2014.

Investment Implications

Overall, the theme of extremely low global central bank rates will continue in 2014, compelling investors to persist in holding risk assets, but it will be tough to again see the equity and risk market gains of 2013 amidst a steady but moderate growth environment.

While we expect continued volatility in the coming months, we believe risk markets will continue delivering solid returns, particularly investment-grade credit. You still get paid to take the default risk inherent in investment-grade corporate bonds. While corporate fundamentals remain attractive, the technicals surrounding the unwinding of quantitative easing will continue to put pressure on corporate spreads. We favour corporate assets to sovereign assets (specifically in Australia and Asia), with a preference for floating rate assets, as floating rate assets will outperform in a secular environment of increasing rates. We particularly like short-maturity, defensive securities (less than 5-year maturities, high-rated global banks, conglomerates and quasi-sovereigns) which are both held in more solid hands and less sensitive to moves in interest-rates.

We have again implemented small positions in Spanish and Italian sovereign bonds with expectations for further ECB funding, providing both support for peripheral economies and a back-stop against major yield rises.